No. 13,148

In the United States Court of Appeals for the Ninth Circuit

HUGH H. EARLE, COLLECTOR OF INTERNAL REVENUE FOR THE DISTRICT OF OREGON, APPELLANT

v.

W. J. JONES & SON, INC., A CORPORATION, APPELLEE

UNITED STATES OF AMERICA, APPELLANT

v.

W. J. JONES & SON, INC., A CORPORATION, APPELLEE

ON APPEALS FROM THE UNITED STATES DISTRICT COURT FOR THE DISTRICT OF OREGON

BRIEF FOR THE APPELLANTS

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BRIEF FOR THE APPELLANTS

OPINION BELOW

The District Court rendered no opinion; its findings of fact and conclusions of law are to be found at R. 52-66.

JURISDICTION

These appeals involve two suits for refund of income and excess profits taxes alleged to have been illegally

and wrongfully withheld from taxpayer, both instituted in the United States District Court for the District of Oregon. The taxes for which refund is sought in District Court Civil No. 5758 (against the Collector) were collected by Hugh H. Earle, who, subsequent to September 1, 1947, was, and now is, the duly appointed, qualified and acting Collector of Internal Revenue for the District of Oregon. (R. 53-54.) The taxes for which refund is sought in District Court Civil No. 5759 (against the United States) were collected by J. W. Maloney, who, prior to September 1, 1947, was the duly appointed, qualified and acting Collector of Internal Revenue for the District of Oregon, and was not in office as Collector of Internal Revenue for the District of Oregon when that action was commenced, and has not been in office since September 1, 1947. (R. 53.) Jurisdiction of the District Court over Civil No. 5758 (against the Collector) exists by virtue of 28 U.S.C., Section 1340, and jurisdiction of the District Court over Civil No. 5759 (against the United States) exists by virtue of 28 U.S.C., Section 1346. (R. 54.)

The two actions involve the same controversy and were divided into two complaints by plaintiff only for pleading and the jurisdiction purposes above noted. (R. 36.) The cases were consolidated by consent of the parties and approval of the court (R. 36-37, 52); they were tried together (R. 76); and a single judgment, which is the judgment appealed from, was entered in both of them (R. 66-67).

On or about April 20, 1945, taxpayer filed its income and excess profits tax returns for the year 1944, disclosing an income tax liability of $19,677.81 and an excess

profits tax liability of $49,871.47, which taxpayer paid in instalments during the year 1945. (R. 55.)

On or about May 16, 1947, taxpayer filed its income tax return for 1946, disclosing an income tax liability of $12,190.32, which taxpayer paid in instalments during the year 1947. (R. 54.)

On or about May 17, 1948, taxpayer filed its income tax return for 1947, disclosing an income tax liability of $154,791.75, which taxpayer paid in instalments during the year 1948. (R. 54.)

On or about March 15, 1949, taxpayer filed its income tax return for the year 1948, in which taxpayer claimed a bad debt deduction of $134,555.21, constituting part of an operating loss for 1948 in the amount of $138,379.48. (R. 54.)

On November 4, 1949, taxpayer filed with the Collector of Internal Revenue for the District of Oregon a refund claim for the calendar year 1946 (Pltf. Ex. 6, R. 172-175), in which taxpayer claimed a refund of $12,190.32, resulting primarily from a net operating loss deduction attributable to the carry-back to 1946 of the $138,379.48 net operating loss claimed to have been sustained in 1948. (R. 55.)

On November 4, 1949, taxpayer filed with the Collector of Internal Revenue for the District of Oregon a refund claim for the year 1947 (Pltf. Ex. 7, R. 176-178), in which taxpayer claimed a refund of $38,030.29, resulting from a net operating loss deduction attributable to the carry-back to 1946 of the $138,379.48 net operating loss claimed to have been sustained in 1948 and the carry-forward from 1946 to 1947 of the

amount of the net operating loss deduction not absorbed by 1946 net income. (R. 55.)

On November 4, 1949, taxpayer filed with the Collector of Internal Revenue for the District of Oregon a refund claim for the year 1944 (Pltf. Ex. 8, R. 179-184), in which taxpayer claimed a refund of excess profits taxes in the sum of $30,865.50, resulting from an unused excess profits credit carried back from 1946 to 1944, due to the elimination of taxpayer's 1946 income by the asserted 1946 net operating loss deductions attributable to the claimed carry-back of the $138,379.48 net operating loss sustained in 1948. This refund claim disclosed the unused excess profits credit carry-back resulted in an asserted income tax deficiency of $14,947. (R. 56.)

Taxpayer did not receive by registered mail any notice of allowance or disallowance of these refund claims for 1944, 1946, and 1947, within the time prescribed in Section 3772 of the Internal Revenue Code, and on September 27, 1950 (R. 3-4), being more than six months after the filing of the refund claims, taxpayer brought the two actions above described in the District Court for recovery of the taxes paid against the Collector (R. 5-14), and against the United States (R. 18-33).

A single judgment was entered in both actions in favor of taxpayer on June 12, 1951, in the amount, in the action against the Collector, of $43,220.61 and, in the action against the United States, of $37,865.50. (R. 66-67.) Notices of appeals from this judgment of the District Court were timely filed by the Collector and the United States, respectively, on August 8, 1951

(R. 67-69), in compliance with 28 U.S.C., Section 2107. Jurisdiction of this Court to hear and determine this appeal is conferred by 28 U.S.C., Section 1291.

QUESTION PRESENTED

Whether the advances to the Mexican Corporation, upon which was founded the alleged bad debt deduction claimed by taxpayer, constituted capital contributions and not loans, and, hence, were not deductible as bad debts within the meaning of Section 23 (k) (1) of the Internal Revenue Code.

STATUTE INVOLVED

Internal Revenue Code:

SEC. 23. DEDUCTIONS FROM GROSS INCOME.

In computing net income there shall be allowed as deductions:

* * * * *

(k) [As amended by Section 124 (a) of the Revenue Act of 1942, c. 619, 56 Stat. 798, and Section 113 (a) of the Revenue Act of 1943, c. 63, 58 Stat. 21] BAD DEBTS.—

(1) *General Rule.*—Debts which become worthless within the taxable year; or (in the discretion of the Commissioner) a reasonable addition to a reserve for bad debts; and when satisfied that a debt is recoverable only in part, the Commissioner may allow such debt, in an amount not in excess of the part charged off within the taxable year, as a deduction. This paragraph shall not apply in the case of a taxpayer, other than a bank, as defined in section 104, with respect to a debt evidenced by a security as defined in paragraph (3) of this subsection.

This paragraph shall not apply in the case of a taxpayer, other than a corporation, with respect to a non-business debt, as defined in paragraph (4) of this subsection.

* * * * *

(26 U.S.C. 1946 ed., Sec. 23.)

STATEMENT

These are actions for refund of excess profits taxes paid by taxpayer for the year 1944 and income taxes paid by taxpayer for the years 1946 and 1947. While the actions technically involve the years 1944, 1946 and 1947, the real basis of the controversy is an alleged 1948 bad debt deduction in the sum of $134,555.21 claimed by taxpayer as the major portion of an alleged net operating loss disclosed on its 1948 income tax return. The Government asserts that the advances upon which the alleged bad debt deduction is based constituted capital contributions to a Mexican corporation and not loans to it and, hence, could not form the basis for a bad debt deduction. Hence, defendants denied the 1948 bad debt deduction and the resulting portion of the 1948 net operating loss.

If the 1948 bad debt deduction is allowable, as held by the court below, it increases taxpayer's 1948 net operating loss by the amount of the deduction. In such event, the net operating loss may be carried back and reflected in the years 1944, 1946 and 1947, and form the basis for the refunds to taxpayer for those years granted in the judgment appealed from. (R. 37, 66-67.)

The cases were tried before Judge McColloch without jury. (R. 52.) Previously a pre-trial order had

been made by Judge Solomon (R. 36-51), containing a statement of the facts admitted by both sides (R. 37-41), identifying a list of eighty exhibits (R. 47-51), and setting forth the contentions of the parties and the issues to be decided.

At the trial two witnesses testified for taxpayer and one for the Government, and the eighty exhibits marked for identification at pretrial were received in evidence. (R. 78-82, 169.)

The findings of the District Court do not set forth the primary facts, but are limited essentially to ultimate conclusions of fact, many of which, the Government contends, are clearly erroneous, for reasons hereinafter set forth. For an understanding of the issue, however, a statement of the primary facts is requisite. The primary facts are documentary in character or contained in uncontradicted testimony of taxpayer's witnesses, and are substantially not in dispute. A statement of these undisputed facts, as far as possible in chronological order, follows:

In June, 1944, one D. D. Kroder interested Clayton R. Jones in a Mexican gold mine located approximately two hundred miles south of the border. (R. 83, Pltf. Ex. 52, R. 255-258.) [1] Kroder had an option to purchase the mining rights for $35,000, $10,000 down and the balance payable out of royalties within four years. (R. 256-257.) Jones contacted a friend, D. E. Harris, who made a preliminary examination and submitted a

[1] The only exhibit marked as defendants' exhibit is No. 80 (revenue agent's report). (R. 169.) Hence, Exhibits 1-79, inclusive, will, without further mention, be understood to be plaintiff's exhibits.

favorable report. Jones then interested John C. Higgins, of Portland, Oregon, who possessed experience in underground mining, which Jones lacked. (R. 84.) They sent two men, selected by Higgins, to make a further examination of the property. This investigation culminated in a mining option dated July 31, 1944, made between Kroder, as first party, and Jones and Higgins, as second parties (Ex. 53, R. 258-261), wherein Kroder granted an option to the second parties to acquire Kroder's option for the purchase of the mine. In the event the second parties exercised the option, the following agreements were to be effective (R. 260-261):

> 4. Parties hereto contemplate the organization of a Mexican corporation to be named as grantee in the deed conveying said mining property and the $35,000 provided by second parties hereto shall be in the form of a loan to said corporation represented by notes of the corporation and repayable within two years from their date, with interest at five per cent. Said notes shall be payable either at or before their maturity before any dividends shall be declared by said corporation.
>
> 5. The stock of the aforesaid corporation shall be distributed one-third to first party and two-thirds to second parties.
>
> 6. First party agrees to devote all of his time to the management of the affairs of said corporation during a development period of four months and he shall receive therefor a salary of Three Hundred Dollars ($300.00) per month. In case the parties shall desire to continue the arrangement with first party for his services after said initial period of four months it shall be under such agreement as to

salary and terms as may be made by the parties hereto.

Kroder was allowed the 1/3 interest in the venture in consideration of finding the project plus the undertaking to devote full time to its development for a period of four months at a salary of $300 a month. (R. 86.) However, about ten days later (August 9, 1944), by a supplemental agreement between the same parties, Kroder consented to reduce his interest in the undertaking to 20%, of which 1/2 was to be held by a certain A. E. Johnson, and the remaining 10% by himself. On the other hand, Kroder was released from the obligation to devote time to the management of its affairs and was not to get any salary. (Ex. 54, R. 262-263.) The next day, on August 10, 1944, D. E. Harris, as agent and trustee of Jones and Higgins, acquired a contract to purchase the mine property from one Robinson, who owned or controlled it. (R. 87-88; Ex. 55, R. 264-269.)

Thereafter, the parties, through Higgins, communicated with Malcolm Little, of Nogales, Arizona, a lawyer, qualified to practice both in the United States and Mexico. (R. 127.) Higgins told him that they planned to organize a Mexican corporation to carry on the mining operation, because there were other parties than Jones and himself; except for this outside participation, he and Jones would have operated as a partnership. Little advised him strongly not to operate as an American partnership and not to organize a new Mexican corporation or American corporation, since an American corporation would probably not be quali-

fied to do business under Mexican laws at all, and, if a new Mexican corporation was organized, the Mexican law would require 51% of the stock to be owned by Mexican citizens. (R. 128.) Instead, Little recommended taking over an existing Mexican corporation, organized before the enactment of the Mexican statute requiring Mexican companies to have at least 51% Mexican stock ownership. (R. 129-130.) Little had preserved in his office the corporate structure of such a Mexican corporation, organized in 1932, and sold it to Jones, Higgins and Harris. (R. 88, 129-130.) This corporation was named "Mina del Refugio, S.A.", usually hereinafter referred to as the "Mexican Corporation". (R. 88.) On October 31, 1944, the Mexican Corporation acquired from their owners the mining rights referred to in Exhibit 55 (R. 88, Ex. 56, R. 269-289), for the sum of $40,000, $10,000 down and $10,000 on August 10th of each of the next succeeding three years. From each annual instalment was to be deducted the amount to be received as royalty in each preceding year by the mine owners, the Mexican Corporation to pay only the difference between $10,000 and the amount of royalties thus received. (R. 274.) On November 20, 1944, an agreement (Ex. 57, R. 290-294) was entered into between Jones, Higgins and Harris as "First Parties" and the Mexican Corporation as the "Company", which provided among others that the first parties had procured the transfer of the mining rights under the agreement of October 31, 1944 (Ex. 56), to the Mexican Corporation, that they had expended $10,000 in making the first payment on the purchase price of the mining claims, and also expended the further sum of $13,668.40 in the investigation, ex-

ploration, development and equipment of these mining properties for operation (R. 290), and that (R. 291-294):

> The Company will require further large sums of money and additional equipment and materials to continue the exploration, development and exploitation of said mining properties and to make further payments on the purchase price thereof, and First Parties hereby offer to provide the Company with money and equipment and materials for the foregoing purposes under the following terms and conditions:
>
> Clauses:
>
> First: First Parties shall provide such sums of money and such items of equipment, materials and supplies for the foregoing purposes as shall be mutually agreed upon by the Company and First Parties, and as consideration therefor, and as consideration for the procurement of the aforesaid option, the Company shall be bound to First Parties as follows:
>
> (a) Promptly after the execution of this agreement, the Company shall execute and deliver to each of First Parties its notes for the full amounts theretofore expended by such party for and on account of the investigation, examination, exploration, development and equipment of the Robinson mining properties, and for payment on the purchase price under the aforesaid option agreement thereon; said notes shall be payable two years after date and shall bear interest at six per cent per annum from the date when the principal sum represented by such note was expended by the payee for the purposes above stated, interest being payable at the maturity of the note.

(b) On or about the last day of each month hereafter, the Company shall execute and deliver to each of the First Parties its note or notes for all amounts advanced to the Company or expended for its benefit by such party during such month, at the request of the officers of the Company, for or on account of the exploration, development, equipment or exploitation of the aforesaid Robinson mining properties or for payment on the purchase price under the aforesaid option agreement, or for other Company purposes; said notes shall be payable two years after date and shall bear interest at six per cent per annum from the date of the advance or the expenditure by the payee of the principal sum represented by such note, interest being payable at the maturity of the note; provided, however, that promptly after the execution of this agreement, First Parties shall pay to the Banco Nacional de Mexico, at Hermosillo, Sonora, for credit to the account of Arthur E. Johnson, Trustee, for the use and benefit of the Company, the sum of 5,000 pesos, Mexican currency; said sum shall be in full payment of the "capital social" of the Company, and shall constitute the Company's "capital social" without any obligation or indebtedness therefor from the Company to said Jones, Harris and Higgins, and without the issuance of any note or notes therefor, and the capital stock of the Company shall thereby become fully paid.

(c) Upon demand of the parties entitled thereto, the Company shall execute and deliver to each of the First Parties its note or notes, payable two years after date, for the agreed purchase price and reasonable value of all used equipment heretofore or hereafter sold and delivered to the Company; the principal sum of said note or notes shall

bear interest at six per cent per annum from the date or dates when the equipment represented thereby shall have been delivered for use at the Robinson mining properties, said interest being payable at maturity.

(d) All monies advanced or expended by First Parties for any of the purposes described in Clauses (a) and (b) above, together with the amounts representing the reasonable purchase price and value to the Company of the mining and milling equipment sold and delivered to the Company as stated in Clause (c) above, together with interest thereon in accordance with the terms above stated, shall become obligations of the Company from the dates when such monies were advanced or expended and from the dates of delivery to the Company of the aforesaid equipment, and the Company shall be and remain indebted under open account for the aforesaid amounts and interest therein as aforesaid to the respective persons who advanced or expended the monies or who sold and delivered the equipment, until such persons shall have been reimbursed by the Company therefor or until the Company shall have executed and delivered to such persons its note or notes therefor as above provided.

(e) Upon demand therefor by the party entitled thereto, the Company shall execute and deliver to each of the First Parties chattel mortgages on all items of equipment sold and delivered to the Company by such party, giving to such party a lien on such items of equipment to secure the payment of the purchase price therefor and the interest thereon as above provided.

Higgins as president and Harris as secretary signed this agreement on behalf of the company. (R. 294.)

Earlier the same day (November 20, 1944), the board of directors of the Mexican Corporation, consisting of Harris, Jones and Higgins, had met in Portland, Oregon, for the purpose of considering (Ex. 58, R. 295)—

> a plan that would enable the Company to procure the money necessary for the exploration, development, operation and acquisition of the mining claims * * *.

Mr. Jones presented to the board a draft of the proposed agreement (Ex. 57), whereby Messrs. Harris, Jones and Higgins offered to advance to the company funds for the foregoing purposes upon the terms stated in the proposed contract (R. 295). The proposed agreement was accepted and ratified (R. 295), and it was further (R. 296-298):

> Resolved that either the President or the Vice President of the Company is authorized and directed to execute and deliver to Messrs. Jones, Harris and Higgins, upon their respective demands, notes of the Company in accordance with the terms of said agreement, in such amounts and at such times as the officers of the Company shall determine are required by the terms of said agreement in consideration for the following:
>
> (a) All monies heretofore or hereafter expended by said Jones, Harris and Higgins, respectively, for and on account of the examination of the properties covered by the aforesaid option and the acquisition of said option and the making of payments thereunder;
>
> (b) All monies heretofore or hereafter advanced or expended by said Harris, Jones and Hig-

gins, respectively, for and on account of the exploration and development of the mining claims covered by the aforesaid option and the prosecution of mining operations thereon;

(c) All monies heretofore or hereafter advanced or expended by said Jones, Harris and Higgins, respectively, for and on account of the purchase, repair, transportation and delivery of mining equipment, materials and supplies used on and in connection with the exploration, development and mining operations carried on by said Jones, Harris and Higgins and/or by this Company on the mining properties covered by said option;

(d) All monies advanced or paid out by said Jones, Harris and Higgins, respectively, for expenses or other obligations of the Company incurred in the course of its business, or deposited by said Jones, Harris and Higgins, respectively, to the credit of Arthur E. Johnson, Trustee in the Banco Nacional de Mexico or the First National Bank of Nogales, and thereafter expended for the use and benefit of the Company; provided, however, that said Jones, Harris and Higgins shall promptly hereafter pay to the Banco Nacional de Mexico, at Hermosillo, Sonora, for credit to the account of Arthur E. Johnson, Trustee, for the use and benefit of the Company, the sum of 5,000 Pesos, Mexican currency; said sum shall be in full payment of the "capital social" of the Company and shall constitute the Company's "capital social" without any obligation or indebtedness therefor from the Company to said Jones, Harris and Higgins, and without the issuance of any note or notes therefor and the capital stock of the Company shall thereby become fully paid;

(e) For such amounts as shall represent the reasonable purchase price and value to the Com-

pany of all mining and milling equipment, materials and supplies owned by said Jones, Harris and Higgins, respectively, and sold and delivered by them to the Company for the Company's use in the exploration, development and mining of the properties described in the aforesaid option.

Third: Resolved that all monies advanced or expended by said Harris, Jones and Higgins for any of the purposes described in Clauses (a), (b), (c), (d) above, together with the amounts representing the reasonable purchase price and value to the Company of the mining and milling equipment, materials and supplies sold and delivered to the Company as stated in Clause (e) above, together with interest thereon in accordance with the terms of the aforesaid proposed agreement, shall become obligations of the Company from the dates when such monies were advanced or expended and from the dates of delivery to the Company of the aforesaid equipment, materials and supplies, and the Company shall be and remain indebted under open account for the aforesaid amounts and interest thereon as aforesaid to the respective persons who advanced or expended the monies or who sold and delivered the equipment, materials and supplies, until such persons shall have been reimbursed by the Company therefor or until the Company shall have executed and delivered to such persons its note or notes therefor as above provided.

Higgins testified at the trial that the whole plan of advances to the Mexican Corporation was set up on the advice of Mr. Little. Higgins had suggested

that 5,000 pesos or about $1,000 seemed inadequate capital, and had also suggested issuance of preferred stock, but Little advised the parties not to tamper with the corporate structure in any way, because of uncertainty of what might happen when the Mexican courts came to interpret the recent statute requiring that operations be 51% owned by Mexican citizens; that it was preferable that they leave the capital stock structure as it was and provide money for the corporation by way of loans. (R. 154-156.) (Due to printer's error the record (154) reads "adequate capital", instead of "*in*adequate" as in the transcript (p. 82); and see R. 156.)

In March, 1945, Jones, Higgins and Harris entered into an agreement (Ex. 59, R. 300-302) which provided among others (R. 300-302)—

> that funds for the acquisition, exploration, development and exploitation of said mining properties, should be contributed as follows: $3,000 by said D. E. Harris and members of his family; 50% of the balance of said funds by Clayton R. Jones, and 50% thereof by John C. Higgins. In pursuance of said agreement, said D. E. Harris has heretofore contributed $1,500; Robert F. Harris has contributed $1,000 and R. Blaine Harris, has contributed $500, making a total contribution by said Harris and members of his family, of $3,000. Said Clayton R. Jones and John C. Higgins have each contributed approximately $15,000 in cash and they have each made additional substantial contributions in mining and operating equipment, and they plan to make further contributions of cash and operating equipment.

4. It has been agreed by and between the parties hereto that ten per cent (10%) of the stock of the aforesaid Corporation shall be issued to Arthur E. Johnson, or his assigns, ten per cent (10%) to Daniel D. Kroder, or his assigns, and the remaining eighty per cent (80%) of the stock of said Corporation shall be divided between Clayton R. Jones, John C. Higgins and the above-named members of the Harris family, in proportion to their respective contributions in cash and in equipment, at its reasonable value, and that such stock shall be so distributed when the total of said contributions, as finally made, has been determined.

It has also been agreed by and between the parties hereto that all of the contributions of said parties, except the amount thereof required to pay up the 5,000 pesos capital stock of said Corporation, shall be regarded as loans to said Corporation, to be represented by notes of said Corporation and to be repayable within two years from the respective dates when said contributions in cash and equipment were made, with interest at five per cent (5%) per annum, and that said notes shall be payable either at or before their maturity, before any dividends shall be declared by said Corporation.

Both Jones and Higgins testified that it was the agreement they were to have stock in proportion to advances made. (R. 110, 160.)

The Mexican Corporation's general ledger (Ex. 51) showed extensive advances by Jones (R. 252-253) and Higgins (R. 254), respectively, during the period from August, 1944, to the end of 1947, amounting in the case of each to more than $150,000. Harris' contribution was limited to $3,000. (R. 255, 300.)

At various intervals beginning with November 30, 1944, and ending December 31, 1946, thirty-two notes of the Mexican Corporation in the aggregate principal amount of $121,763.74 were issued to Jones, each payable in two years with interest at 6%, in return for cash advances made to the Mexican Corporation. (R. 91.)[2]

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[2] The notes were admitted in evidence as Exhibits 13 to 44, inclusive (R. 79), each bearing the following dates and in the following amounts:

Exhibit No.	Date	Amount
13	11/30/44	$5,000.00
14	11/30/44	545.71
15	11/30/44	620.40
16	11/30/44	3,165.34
17	11/30/44	1,477.88
18	12/31/44	2,109.02
19	1/31/45	2,870.79
20	2/28/45	1,506.28
21	3/31/45	1,332.69
22	4/30/45	1,787.26
23	5/31/45	2,750.46
24	6/30/45	2,475.62
25	7/31/45	1,894.50
26	8/7/45	5,000.00
27	8/31/45	2,499.67
28	9/7/45	5,300.00
29	9/30/45	3,607.62
30	10/31/45	2,212.53
31	11/30/45	2,503.96
32	12/30/45	2,575.76
33	1/31/46	2,155.70
34	2/28/46	2,828.67
35	3/30/46	6,018.42
36	4/30/46	6,935.80
37	5/31/46	9,905.28
38	6/29/46	6,580.24
39	7/31/46	8,673.25
40	8/31/46	8,598.11
41	9/30/46	5,693.83
42	10/31/46	3,790.13
43	11/30/46	4,827.92
44	12/31/46	4,520.90

These exhibits form part of the record on appeal (R. 71-72) and should be available to the Court at the time of argument.

Above that amount Jones had made additional advances in the sum of about $30,000, which made the total of his advances, as aforesaid, in excess of $150,000 (R. 91). Additional notes were issued to Jones representing these advances in the amount of $30,472.21. (R. 367.)

The contributions made by Jones to the Mexican Corporation had been made by withdrawing funds from taxpayer corporation, W. J. Jones & Son, Inc., the withdrawals being charged to Jones' personal account. (R. 92-93, 104-105.) Jones and members of his family owned all of the outstanding stock of taxpayer corporation (R. 104), of which Jones personally owned from 47% to 59% between 1945 and 1948 (R. 109; Deft. Ex. 80, R. 364). Taxpayer is in the stevedoring and ship fitting business. (R. 114.)

The notes were sold to taxpayer at their face value, without recourse. (R. 92.) On August 31, 1946, Jones endorsed to taxpayer corporation twenty-eight of the thirty-two notes issued by the Mexican Corporation in the face amount of $102,930.96. (Exs. 13-40, R. 92, 94.) On December 31, 1946, Jones endorsed the remaining four notes (Exs. 41-44) to taxpayer corporation in the face amount of $18,832.78 (R. 92, 94). Jones was also credited by taxpayer with the accrued interest of $4,654.57 on the twenty-eight notes transferred in August. No interest was credited to Jones for the four notes transferred in December, 1946, these having been issued on September 30, October 31, November 30, and December 31, 1946. After these credits Jones still owed taxpayer corporation three

or four thousand dollars. (R. 94.) See the journal entries for these transactions on taxpayer's books. (Ex. 65, R. 319, and Ex. 66, R. 321.)

The stock record book of the Mexican Corporation reveals that its 5,000 shares stood in the names of Enrique Torres and M. C. Little from January 11, 1932, to March 22, 1948. (Ex. 49, R. 241-242.) On March 22, 1948, all the stock was issued as follows (R. 160, 243, 245, 366): To Higgins—2,256 shares; Jones—2,156 shares; Scott—300 shares; Wells—250 shares; D. E. Harris—19 shares; R. L. Harris—13 shares; and R. B. Harris—6 shares.

During the same period between August, 1944, and the end of 1947, Higgins had advanced to the Mexican Corporation approximately the same sums as Jones (R. 114), for which he also received notes in the amount of $153,142.44 (R. 145, 367).

In 1948 it was ascertained that the mining venture would probably not bring the large profits theretofore anticipated as the rich veins of ore became exhausted and no new veins were found. (R. 100-101.) In November, 1948, it was decided to abandon the project and the engineer on the job was authorized to sell the machinery and equipment. (R. 101-103.)

Neither the principal nor interest [3] on the notes was paid, except that a small amount was realized upon liquidation of the project towards the end of 1948 and

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[3] Taxpayer being on the accrual basis, each month accrued interest on the notes transferred to it and paid income taxes on the interest so accrued. (R. 94-95.) However, in connection with disallowance of the bad debt deduction, adjustment was made reducing taxpayer's income for such accrued interest reported. (R. 163.)

applied *pro rata* on the outstanding notes. The liquidating agreement between the engineer at the mine and the Mexican Corporation provided that (Ex. 75, R. 344-345):

> 3. By December 31, 1948, if possible, or as soon thereafter as it can be accomplished, you are to pay from the company's funds on hand, or in bank, all of the Company's outstanding accounts, pay rolls and liabilities, and you are to transmit to the Valley National Bank, the full balance of any funds then on hand in Hermosillo for deposit in the account of Mina del Refugio, S. A., except that you may retain, as a revolving fund, in the bank at Hermosillo, a balance of 5,000 pesos, or its equivalent in United States currency, for your convenience in meeting local expenses involved in the dismantling, shipping, handling and sale of the equipment, materials and supplies.

The board of directors of the Mexican Corporation in a resolution ratified this agreement and adopted a resolution (Ex. 76, R. 352-353)—

> that the officers of the Company be and hereby are authorized and directed to make a pro rata distribution to the holders of the outstanding notes and other obligations of the Company of any and all funds of the Company realized under the agreement with Mr. Klamt confirmed in the letter from Mr. Higgins to Mr. Klamt dated December 27, 1948, plus any funds of the Company on deposit in its bank account after payment of all prior liabilities.

The entire amount to be salvaged under this agreement was estimated to be $22,500 (R. 350-351), and was

apportioned among the note holders by agreement as follows (R. 375):

John C. Higgins	50%	$11,250.00
W. J. Jones & Son, Inc.	39%	8,775.00
Clayton R. Jones	10%	2,250.00
Dennison E. Harris	1%	225.00
		$22,500.00

Taxpayer, on December 31, 1948, entered on its books an estimated recovery on the notes received from Jones in the amount of $8,755 [4] and charged off on its books the balance of $134,555.21 (notes, $121,763.74, plus interest receivable $21,566.47) as a bad debt. (R. 58-59, 92-93, 95-96; taxpayer's journal entries, Ex. 78, R. 358, 360.)

The deduction of this item from gross income for 1948 as a bad debt deduction was denied by the Commissioner (R. 162-163), and the present suits followed.

Upon this record the District Court found as facts, among other things, as follows:

When the thirty-two notes were received by taxpayer in 1946, for an aggregate consideration of $126,418.31, the notes were reasonably worth this consideration and taxpayer and the officers of the Mexican Corporation fully expected that the notes and interest would be fully paid (Finding XVII, R. 57); that the thirty-two notes were worthless in 1948 to the extent of $134,555.21, this amount being the difference between $143,330.21 (the consideration paid and accrued by taxpayer for the notes) and $8,775 (the maximum amount which tax-

[4] The actual amount recovered was $8,694.42. (R. 93.)

payer could expect to recover on the notes) (Finding XX, R. 58). At no time did taxpayer own any capital stock or any other equity interest in the Mexican Corporation (Finding XXII, R. 59); advances in the aggregate sum of $308,378.39 were made by Jones, Higgins and Harris, evidenced by notes duly made, executed and delivered by the Mexican Corporation (including the thirty-two notes assigned by Jones to taxpayer for value), and that at the time of making these advances Jones, Higgins and Harris intended that the advances should constitute loans and create a debtor-creditor relationship, and all subsequent actions of Jones, Higgins and Harris in regard to these advances (and the notes evidencing same), have been consistent with such intention that the advances constituted loans and created a debtor-creditor relationship (Finding XXV, R. 60).

The lower court further found that Kroder and Johnson never made any advances or contributions to the Mexican Corporation, and the 80% balance of the capital stock of the Mexican Corporation was owned by Jones, Higgins and Harris (Finding XXVII, R. 61); that the mining rights acquired by Jones, Higgins and Harris from Kroder and Johnson were transferred to the Mexican Corporation through the execution of an option and lease agreement dated October 31, 1944, in the name of the Mexican Corporation (Ex. 56), and the mining rights at the time of this transfer to the Mexican Corporation had a very substantial value in excess of the amount payable under the option and lease agreement, and this transfer of mining rights to the Mexican Corporation by Jones, Higgins and Harris constituted

contributions to the capital of the Mexican Corporation (Finding XXVIII, R. 61). The District Court also found that in the spring of 1945 a third person, Walter M. Wells, and his associates paid $5,000 for the 10% stock interest of Kroder in the Mexican Corporation, and in March, 1946, Jones and Higgins paid $4,000 for the 9% stock interest of Johnson in the Mexican Corporation (Johnson previously having transferred a 1% to an associate of Wells), and the asset accounting for such value of the stock was the excess in the value of the mining rights over the amounts payable under the option and lease agreement. (Finding XXIX, R. 61-62.) The court also found that whether or not the transfer of the mining rights by Jones, Higgins and Harris to the Mexican Corporation constituted contributions to capital, the advances made by Jones, Higgins and Harris to the Mexican Corporation evidenced by the notes duly issued by the Mexican Corporation were intended to constitute, and did constitute, loans rather than contributions to capital (Finding XXX, R. 62); and that the advances to the Mexican Corporation were not made by the stockholders thereof in direct proportion to their stock ownership, because Kroder and Johnson owned 20% of the capital stock, but made no advances whatsoever to the corporation (Finding XXXI, R. 62).

The lower court also found that there were business reasons why Jones, Higgins and Harris intended that their advances to the Mexican Corporation should constitute loans, in that they desired to be repaid such advances before anything was received by or accrued to the finders (Kroder and Johnson), who paid nothing

for their 20% stock interest, and they desired to be in as strong a position as possible in the event that the Mexican authorities or general creditors made claims against the corporation. (Finding XXXII, R. 62.)

The District Court also found that at the time of the execution of the agreements under which the loans were made to the Mexican Corporation (Exs. 53, 57 and 59), Jones, Higgins and Harris expected that the advances required by the corporation would not exceed $50,000, and had no idea that the advances would exceed $300,000. They believed that the loans would be repaid prior to the maturity dates of the notes and based on their investigations, available engineering reports and blocked-out ore deposits, such belief was reasonable. The liabilities evidenced by the notes of the Mexican Corporation were agreed to be incurred by Jones, Higgins and Harris in the expectancy that the Mexican Corporation would be successful and pay off the obligations. (Finding XXXIII, R. 63.)

The District Court also found that the loans evidenced by the thirty-two notes charged off by taxpayer in 1948 were consistently treated as loans and debt obligations on the books of taxpayer and on the books of the Mexican Corporation. (Finding XXXIV, R. 63.)

Upon the basis of these findings the lower court concluded as a matter of law, among others, that $134,555.21 of the net operating loss sustained by taxpayer for its taxable year 1948 was a bad debt allowable as a deduction for 1948 under Section 23 (k) of the Internal Revenue Code, and entitled taxpayer to the refunds claimed by it for 1944, 1946 and 1947 (R. 63-64); that the thirty-two notes of the Mexican Corporation owned

by taxpayer in 1948 constituted debt obligations within the meaning of the Internal Revenue Code, Section 23 (k), became worthless in 1948 to the extent of at least $134,555.21, and were properly charged off on its books in 1948 in that amount; further, that taxpayer is entitled to recognition for tax purposes as a separate entity distinct from Clayton R. Jones, and that the thirty-two notes in the hands of taxpayer constituted debt obligations and did not represent contributions to capital; and further that the stock ownership of Clayton R. Jones in the Mexican Corporation, or his activities in regard thereto, are not attributable to taxpayer (R. 64); and that in the event they are attributable to taxpayer the fact findings support the court's conclusion that the net operating loss in question was a bad debt allowable for 1948 under Section 23 (k) of the Internal Revenue Code, that the taxes for which refund is sought were excessive, and were illegally and wrongfully withheld from taxpayer, and the Commissioner erred in failing to allow taxpayer's claims for refund (R. 65).

From the adverse judgment of the District Court (R. 66-67) entered upon these findings and conclusions, appellants seek review by this Court.

STATEMENT OF POINTS TO BE URGED

1. That the District Court erred in finding and holding that the taxpayer was entitled to a bad debt deduction of $134,555.21 in computing its taxable income for the calendar year 1948.

2. That the District Court erred in finding and holding that 32 notes owned by the taxpayer in 1948, identi-

fied as Exhibits 13 to 44, inclusive, constituted debt obligations within the meaning of Section 23 (k) of the Internal Revenue Code.

3. That the District Court erred in finding and holding that taxpayer properly charged off on its books in 1948 as a bad debt the $134,555.21, as representing the extent to which the 32 notes, Exhibits 13 to 44, inclusive, were then considered worthless.

4. That the District Court erred in finding and holding that the advances evidenced by the 32 notes, Exhibits 13 to 44, inclusive, did not represent contributions to the Mexican corporation's capital by Clayton R. Jones.

5. That the District Court erred in finding and holding that if the stock ownership of Clayton R. Jones in the Mexican corporation or his activities in regard thereto are attributable to the taxpayer, then Findings of Fact XXIII through XXXIV support the District Court's conclusion that $134,555.21 of taxpayer's $138,-379.48 net operating loss for 1948 was a bad debt, allowable as a deduction for 1948 under Section 23(k) of the Internal Revenue Code.

6. That the District Court erred in finding and holding that the advances made to the Mexican corporation by Clayton R. Jones, evidenced by the 32 notes, Exhibits 13 to 44, inclusive, constituted loans, for income tax purposes, as distinguished from contributions to capital.

7. That the District Court erred in finding and holding that Clayton R. Jones, John C. Higgins and D. E. Harris intended that their advances to the Mexican corporation should constitute loans within the meaning

of the internal revenue laws, as distinguished from contributions to capital.

8. That the District Court erred in finding and holding that the advances made by Clayton R. Jones, John C. Higgins and D. E. Harris to the Mexican corporation created a debtor-creditor relationship within the meaning of the internal revenue laws.

9. That the District Court erred in basing its findings, conclusions and holdings upon the mere formal appearances of the transactions relating to the advances made to the Mexican corporation by Clayton R. Jones, John C. Higgins and D. E. Harris and ignoring the substance of the transactions.

10. That the District Court erred in finding and holding that Clayton R. Jones, John C. Higgins and D. E. Harris expected that their advances to the Mexican corporation would be repaid prior to the maturity dates of the notes issued to cover such advances.

11. That the District Court erred in finding and holding that the taxpayer is entitled to recognition for tax purposes as a separate entity distinct from Clayton R. Jones, insofar as the stock ownership of Clayton R. Jones in the Mexican corporation, and his advances thereto evidenced by notes transferred to the taxpayer, are concerned.

12. That the District Court erred in finding and holding that the advances to the Mexican corporation were not made by the stockholders thereof in direct proportion to their stock interests.

13. That the District Court erred in failing to find and hold that the advances made by Clayton R. Jones, John C. Higgins and D. E. Harris to the Mexican cor-

poration were intended to be, and were in fact in proportion to their stock interests.

14. That the District Court erred in finding and holding that the taxes herein sought to be recovered were excessive and were illegally and wrongfully withheld from taxpayer.

15. That the District Court erred in granting judgment herein in favor of the taxpayer and against the United States and against the Collector, Earle.

16. That the District Court erred in failing to find and hold that the advances made to the Mexican corporation by Clayton R. Jones, John C. Higgins and D. E. Harris were intended to and did constitute contributions to capital of the Mexican corporation.

17. That the District Court erred in failing to enter judgment for the defendants and against the taxpayer.

SUMMARY OF ARGUMENT

The statutory grant of the bad debt deduction is premised upon the establishment by a taxpayer of the existence of the "debts" sought to be deducted, and in applying its terms the first consideration is whether a given taxpayer was in fact owed any debt at all. Furthermore, since taxpayer bases its claim upon a deduction the rule of construction is strict. The bad debt deduction, like other deductions, is a matter of legislative grace and the burden is upon taxpayer to show that the facts bring the case squarely within the terms of the legislative grant. Under this strict standard to escape liability a taxpayer must show clear indebtedness, which taxpayer here plainly failed to establish. On the contrary, the record establishes that the Mexi-

can Corporation was not indebted to taxpayer in the amount, which taxpayer seeks to deduct as a bad debt. The record in main part consists of documentary evidence and undisputed facts, and hence, on review this Court is in as good a position as the trial court to evaluate the evidence, and on settled principles may reject the trial judge's finding and substitute its own.

The circumstance that promissory notes in ordinary form were issued in consideration for the advances is in no sense conclusive. The formal characterization of the advances as loans on the part of the controlling stockholders is not permitted to obscure the true substance of the transaction. Among the undisputed facts which establish that the District Court was clearly in error in reaching its ultimate conclusion of loan, in that the lower court disregarded the substance of the transaction and was persuaded by form alone are the following:

A. The proportionate financial interests of the controlling stockholders, Jones and Higgins, in the Mexican Corporation were substantially the same, whether treated as stockholders or creditors. Indeed, the parties' studied purpose, as evidenced by written agreement made almost at the inception of the enterprise and their testimony at the hearing, was to effect a lending and investing transaction giving so-called creditors, as stockholders, proprietary interest in proportion to their loans.

B. The plan of cloaking what actually were capital contributions, under the guise of loans, was set up under the advice of Mexican counsel, to avoid a recent Mexican statute requiring such operations to be 51% owned

by Mexican citizens. Notes were issued to represent the advances in order to avoid the unfavorable rule of Mexican law, not because they were intended genuinely to create debts. A device resorted to in order to avoid a Mexican law cannot constitute an excuse for depriving the United States of taxes or disguise the true nature of a deduction claim granted under the revenue laws of the United States.

C. Similarly, avoidance of the unfavorable Mexican law and not a purpose to subordinate the finders' interests caused the critical contributions to be represented by so-called notes rather than by preferred stock.

D. Although the notes were formally due two years from date and bore interest, no effort was made to collect them when due, nor was any effort made to collect interest upon them.

E. On liquidation, the stockholders subordinated their claims against the corporation represented by notes to the claims of creditors and treated these securities not like debt, but like capital investment.

F. The part of the Mexican Corporation's financial structure attributed to stock was $1,000 as against supposed indebtedness to stockholders in excess of $308,000, or 1 to 308. Even assuming, *arguendo,* that the stock possessed $50,000 in value, by reason of alleged mining rights, the resulting ratio of investment of $50,000 to $308,000 in debt, or more than one to six, in this speculative enterprise, was completely unreal. Thus, the Mexican Corporation's financial structure, in which a wholly inadequate part of the investment was attributed to stock while the bulk was represented by so-called notes to stockholders, was lacking in the sub-

stance necessary for recognition for tax purposes and must be interpreted in accordance with realities.

G. Taxpayer was a mere *alter ego* for Jones and took the notes with complete notice of all the transactions involved and without recourse to him. Jones and members of his family owned all the outstanding stock of taxpayer corporation and its position does not differ from that of the stockholder Jones.

In summary, the court below disregarded substance for form and sustained the wholly useless temporary compliance with statutory literalness which the Supreme Court has condemned as futile.

ARGUMENT

The Advances to the Mexican Corporation, Upon Which Was Founded the Alleged Bad Debt Deduction Claimed by Taxpayer, Constituted Capital Contributions and Not Loans, and Hence Were Not Deductible as Bad Debts Within the Meaning of Section 23 (k) (1) of the Internal Revenue Code

Taxpayer invokes the provisions of Section 23 (k) (1) of the Internal Revenue Code, *supra,* under which Congress has "allowed" as a deduction from gross income—

> Debts which become worthless within the taxable year; * * * when satisfied that a debt is recoverable only in part, the Commissioner may allow such debt, in an amount not in excess of the part charged off within the taxable year, as a deduction.

After giving credit for estimated recovery in the amount of $8,775, taxpayer contends for and the court below has allowed full deduction of the balance of $134,555.21 charged off on its books as a bad debt. On

the other hand, the Government contends that taxpayer's investment in the Mexican Corporation did not constitute a loan, but contributions of capital, and, hence, the amount involved was deductible, not in full, but, if at all, at the lesser capital loss rates. (See Internal Revenue Code, Section 117 (26 U.S.C. 1946 ed., Sec. 117); R. 45-46, 161-162.)

1. Clearly, the statutory grant of the bad debt deduction is premised upon the establishment by a taxpayer of the existence of the "debt" sought to be deducted. The burden is incumbent upon taxpayer, inherent in the particular statutory foundation of its claim to establish the existence of a "debt".

Taxpayer bases its claim upon a deduction and the bad debt deduction, like other deductions, is a matter of legislative grace. The rule of construction is strict. It does not turn upon general equitable considerations; only if there is clear provision therefor can any particular deduction be allowed. *Equitable Society* v. *Commissioner,* 321 U.S. 560, 564; *New Colonial Co.* v. *Helvering,* 292 U.S. 435, 440; *Deputy* v. *duPont,* 308 U.S. 488, 493; *Brown-Rogers-Dixson Co.* v. *Commissioner,* 122 F. 2d 347, 350 (C.A. 4th); *Pacific Southwest R. Co.* v. *Commissioner,* 128 F. 2d 815, 817 (C.A. 9th), certiorari denied, 317 U.S. 663. The burden is upon taxpayer to show that the deduction claimed clearly falls within the terms of the statute, and, thus, includes the burden of proving that there was an "indebtedness". *Commissioner* v. *Drovers Journal Pub. Co.,* 135 F. 2d 276, 278, 279 (C.A. 7th). In *White* v. *Commissioner,* 67 F. 2d 726, 728, this Court said:

> It is conceded by appellants, as it must be under the authorities, that no deduction from income can be claimed as a matter of right and whatever deduction may be taken is solely a matter of statutory grant. *Lloyd* v. *Commissioner* (C.C.A.) 55 F. (2d) 842. *The burden is upon the taxpayer to prove that the facts bring the case squarely within the deduction provisions of the statute. Burnet* v. *Houston,* 283 U.S. 223, 51 S. Ct. 413, 75 L. Ed. 991; *Reinecke* v. *Spalding,* 280 U.S. 227, 50 S. Ct. 96, 74 L. Ed. 385. (Italics supplied.)

See also to this effect *Interstate Transit Lines* v. *Commissioner,* 319 U.S. 590, 593, and *Boehm* v. *Commissioner,* 326 U. S. 287, 294, rehearing denied, 326 U. S. 811.

Applying this principle instantly, the taxing statute allows deduction for bad "debts", and taxpayers who seek to take advantage of the legislative grant must show facts squarely bringing them within its terms. Surely this strict standard is not satisfied by the proof of ambiguous and equivocal circumstances, which may be read to point either to investment or to debt. To escape liability taxpayer must show clear indebtedness and it does not comply with this well settled rule, where, as here, the evidence reveals only a hybrid situation, which taxpayer might interpret either way—for stock or for debt—as events transpired and their advantage proved. Certainly, in generously granting the deduction Congress did not intend and the statute should not be misread to subject the amount of tax liability to the substantially untrammelled control of any taxpayer or group of taxpayers.

2. The record establishes the conclusion of the District Court to be clearly erroneous that the Mexican Corporation was indebted to taxpayer in the amount, which taxpayer seeks to deduct as a bad debt. The record in main part consists of documentary evidence and undisputed facts and the findings of the trial court were essentially inferences drawn from such evidence. The oft-cited holding of the Supreme Court in *United States* v. *Gypsum Co.*, 333 U. S. 364, rehearing denied, 333 U. S. 869, which reversed District Court findings based on evidence of this precise character, is thus here directly applicable. There the Court said (pp. 394-396):

> In so far as this finding and others to which we shall refer are inferences drawn from documents or undisputed facts, heretofore described or set out, Rule 52 (a) of the Rules of Civil Procedure is applicable. That rule prescribes that findings of fact in actions tried without a jury "shall not be set aside unless clearly erroneous, and due regard shall be given to the opportunity of the trial court to judge of the credibility of the witnesses." It was intended, in all actions tried upon the facts without a jury, to make applicable the then prevailing equity practice. Since judicial review of findings of trial courts does not have the statutory or constitutional limitations on judicial review of findings by administrative agencies or by a jury, this Court may reverse findings of fact by a trial court ~~were~~ where "clearly erroneous." The practice in equity prior to the present Rules of Civil Procedure was that the findings of the trial court, when dependent upon oral testimony

where the candor and credibility of the witnesses would best be judged, had great weight with the appellate court. The findings were never conclusive, however. A finding is "clearly erroneous" when although there is evidence to support it, the reviewing court on the entire evidence is left with the definite and firm conviction that a mistake has been committed.

The government relied very largely on documentary exhibits, and called as witnesses many of the authors of the documents. Both on direct and cross-examination counsel were permitted to phrase their questions in extremely leading form, so that the import of the witnesses' testimony was conflicting. On cross-examination most of the witnesses denied that they had acted in concert in securing patent licenses or that they had agreed to do the things which in fact were done. Where such testimony is in conflict with contemporaneous documents we can give it little weight, particularly when the crucial issues involve mixed questions of law and fact. Despite the opportunity of the trial court to appraise the credibility of the witnesses, we cannot under the circumstances of this case rule otherwise than that Finding 118 is clearly erroneous.

Following the *Gypsum* case (and distinguishing *United States* v. *Yellow Cab Co.,* 338 U.S. 338, on the ground that there the oral testimony was not incompatible with inferences which could reasonably be drawn from the documentary evidence), the Court of Appeals for the Second Circuit, in *Orvis* v. *Higgins,* 180 F. 2d 537, certiorari denied, 340 U.S. 810, stated

the rule properly applicable to the instant record as follows (pp. 539-540):

> Where a trial judge sits without a jury, the rule varies with the character of the evidence: (a) If he decides a fact issue on written evidence alone, we are as able as he to determine credibility, and so we may disregard his finding. (b) Where the evidence is partly oral and the balance is written or deals with undisputed facts, then we may ignore the trial judge's finding and substitute our own, (1) if the written evidence or some undisputed fact renders the credibility of the oral testimony extremely doubtful, or (2) if the trial judge's finding must rest exclusively on the written evidence or the undisputed facts, so that his evaluation of credibility has no significance. (c) But where the evidence supporting his finding as to any fact issue is entirely oral testimony, we may disturb that finding only in the most unusual circumstances.

Under these principles in the cited case, the Court of Appeals rejected the trial judge's finding. So here, the trial court's finding of debt as against loan should be rejected. In view of the undisputed facts and the documentary evidence, this Court is in as good a position as the trial court to evaluate the evidence. Recently, the *Orvis* case has also been quoted and followed by the Court of Appeals for the Seventh Circuit, which, in *Fritz* v. *Jarecki,* 189 F. 2d 445, reversed an ultimate finding of the District Court and dismissed a taxpayer's complaint.

Indeed, this Court has not hesitated to reverse fact findings (applying Rule 52 (a), Federal Rules of Civil

Procedure, and the rule in the *Gypsum* case), when it was concluded that a mistake had been made by the trial court, and also significantly where the fact issue was one of intent in transferring property, namely, on the one hand, to clear away objections to marriage, or, on the other hand, in contemplation of death. *Gillette's Estate* v. *Commissioner*, 182 F. 2d 1010. Compare, on the other hand, this Court's decision in *Smyth* v. *Barneson,* 181 F. 2d 143, affirming the District Court, where, as in the *Yellow Cab* case, oral testimony was not incompatible with undisputed facts and a question of credibility was involved.

Finally, in *Wilshire & West. Sandwiches* v. *Commissioner,* 175 F. 2d 718, this Court reversed findings of the Tax Court, where the issue was similar to that instantly involved, on the ground that while there were features looking both ways, as to whether advancements in the cited case were loans or stock purchases, those sustaining the conclusion that the transaction was a loan greatly preponderated. See also *United States* v. *South Georgia Ry. Co.,* 107 F. 2d 3 (C.A. 5th).

3. The circumstance that promissory notes in ordinary form were issued in consideration for the advances is, of course, in no sense conclusive. Thus, it has repeatedly been held that (*In re Fechheimer Fishel Co.,* 212 Fed. 357, 360 (C.A. 2d), certiorari denied, *sub nom. Dellevie* v. *Fechheimer-Fishel Co.,* 234 U. S. 760)—

> the fact that an instrument is called a "bond" is not conclusive as to its character. It is neces-

> sary to disregard nomenclature and look to the substance of the thing itself.

The misuse of words of art cannot change the legal conclusions. *Bakers' Mutual Coop. Ass'n* v. *Commissioner,* 117 F. 2d 27, 28 (C.A. 3d); *Hazel Atlas Glass Co.* v. *Van Dyk & Reeves,* 8 F. 2d 716, 720 (C.A. 2d), certiorari denied, *sub nom. Van Dyk* v. *Young,* 269 U. S. 570; *Commissioner* v. *Smoll Fils Associated,* 110 F. 2d 611, 613 (C.A. 2d); *Brown-Rogers-Dixson Co.* v. *Commissioner, supra,* p. 349.

The parties' formal designation of the advances is surely not decisive, but must yield, when there are facts which even indirectly give rise to inferences contradicting them. *Schnitzer* v. *Commissioner,* 13 T. C. 43, 60-61, affirmed by this Court on the basis of the Tax Court's opinion, 183 F. 2d 70, certiorari denied, 340 U. S. 911.

4. Among the undisputed facts, which establish that the District Court in reaching its ultimate conclusion of loan, disregarded the substance of the transaction and was persuaded by form alone, are the following:

A. This Court held in *Wilshire & West. Sandwiches* v. *Commissioner, supra,* p. 721:

> The effect of a lending and investing transaction giving creditors, as stockholders, proprietary interest in proportion to their loans, subjects the transaction to close scrutiny,

even though, as a matter of law, the transaction need not be regarded as a stock investment, regardless of intent. Yet precisely such a lending and investing

transaction concededly was present and deliberately purposed here. Jones and Higgins completely managed and controlled the Mexican Corporation as well as owned more than 88% of the stock of their alleged debtor. The proportionate financial interests of Jones and Higgins in the Mexican Corporation were substantially the same, whether treated as stockholders or creditors. Indeed, this was the parties' studied purpose, as evidenced by written agreement made almost at the inception of the investment. Exhibit 59 quoted in the Statement, *supra,* an agreement between Jones, Higgins and Harris, made in March, 1945, provided that after setting aside 20% of the stock for the finders (R. 301)—

> the remaining eighty per cent (80%) of the stock of said Corporation shall be divided between Clayton R. Jones, John C. Higgins and the above-named members of the Harris family, in proportion to their respective contributions in cash and in equipment, at its reasonable value, and that such stock shall be so distributed when the total of said contributions, as finally made, has been determined.

On cross examination, both Jones and Higgins testified that the agreement was that they should have stock in proportion to advances made. (R. 110, 160.) Moreover, it is additionally significant that the stock was not to be distributed until the total of contributions in cash and equipment, as finally made, should have been determined.

In both respects the agreement was carried out. The advances by Jones and Higgins were substantially

in proportion to stockholdings. To recapitulate the facts already appearing in the Statement, and as set forth in defendants' Exhibit 80, the advances made to the Mexican Corporation, for which it issued notes, and the proportion held by each stockholder-noteholder were as follows (R. 367):

Mina Del Refugio
Notes

Payee	Amount		%
John C. Higgins, Portland, Oregon	$153,142.44		49.7%
W. J. Jones & Son, Inc. (By assignment from Clayton R. Jones), Portland, Ore.	121,763.74	39.4%	
Clayton R. Jones, Portland, Ore.	30,472.21	9.9%	49.3%
Dennison E. Harris, Escondido, Calif.	3,000.00		1.0%
Total notes owing 12/31/48	$308,378.39		100.0%

Thus, the total advances by Higgins were $153,142.44, and by Jones, $152,235.95. Again, the stock was held in substantially the same proportions. Of the 5,000 shares issued, 2,256 shares or 45.12% were held by Higgins and 2,156 shares or 43.12% were held by Jones. (R. 160, 366.)[5]

Moreover, the agreement (Exhibit 59) was further carried out by the 80% of the stock not being distrib-

[5] Jones and Higgins eventually acquired more than 80% of the stock, as a result of their purchase of approximately 9% of the stock from one of the finders, A. E. Johnson, Johnson having become ill. (R. 96-97; Ex. 63, R. 315-316.)

The Harris family never advanced more than their original contribution of $3,000 (Ex. 59, R. 300-301), and eventually received 38 shares or .0075% of the stock, i.e., approximately 1% of the 80% of stock distributed under the terms of Exhibit 59, being substantially in proportion to their contribution to the total advances.

uted until March, 1948, by which time their contributions to the Mexican Corporation had been completed and it could be determined what proportion of contributions were actually advanced by Jones and Higgins, respectively. (R. 160; Ex. 49, R. 241-245, Ex. 80, R. 366.) The mere existence of such an agreement is incompatible with the characterization of the advances as loans or any genuine intention that the advances were to be repaid, and establishes that they in substance all along constituted capital contributions, which were to receive formal recognition through stock ownership, as soon as their proportionate amount was finally determined and, hence, the proportionate proprietorship in the Mexican Corporation bought by the advances could be computed. Subjecting the instant transaction to the close scrutiny required by the cited ruling of this Court, clearly no debt transaction was intended or involved. By the end of 1947 all advances by Jones and Higgins had been completed. (R. 252-254.) By early March, 1948, the likelihood of failure was recognized. (R. 100-101; Ex. 71, R. 331-333.) Thus, as arranged by agreement in advance, the formal issuance and distribution of the stock thereafter in March, 1948, was a mere formal recognition of the proprietary interest which the investments of the previous years (under the guise of loans) had bought in the capital of the Mexican Corporation.

B. That the notes actually represented risk capital and not loans, which the stockholders who made the advances genuinely and reasonably expected would be repaid, clearly appears from the testimony of Higgins, already summarized in the Statement, *supra*. Higgins

recognized that the 5,000 pesos or $1,000 paid in for the stock was inadequate capital and his first suggestion was to issue more stock. (R. 154, 156.) He testified on recross-examination (R. 156-157):

> Q. Then you recognized the $1,000 you paid in, or the 5,000 pesos, was inadequate capital, didn't you, Mr. Higgins?
>
> A. It was inadequate in the sense that it was not anything like as much money as this company would require to operate, and it was obvious that the company would have to raise money in some other way, by loans or otherwise.
>
> Q. Your first reaction was to issue more stock?
>
> A. To issue more stock, but when he explained the dangers of such operation, under the then current situation under Mexican law, and advised us to put in the money by loans and notes, I accepted his advice and thought it was good advice.

Indeed, the whole plan of cloaking what actually were capital contributions, under the guise of loans was set up under the advice of Mr. Little, the Mexican lawyer, to avoid the recent Mexican statute requiring such operations to be 51% owned by Mexican citizens. (R. 154-156.) Except for this provision of Mexican law, clearly stock would have been issued (and not notes) in consideration for the large sums advanced by the stockholders as original capital to place the enterprise into operation and to purchase the mine from the owners. The stockholders were merely investing the amounts at the risk of the business; any inference that they genuinely intended the amounts to be repaid absolutely and in any event surely is clearly wrong. Notes were issued

to represent the advances to avoid the unfavorable rule of Mexican law, not because they were intended genuinely to create debts. No one dealing with such a speculative enterprise at arm's length would ever under like circumstances have loaned this money on unsecured notes or expected it to be repaid in any event within a definite two year period plus interest (or at all). It was clearly wrong for the trial court to find that these stockholders made their contributions with any such expectation.

Surely, there is no warrant for permitting a device, indisputably resorted to in order to avoid a Mexican law, to be employed as an excuse for depriving the United States of taxes or to disguise the true nature of a deduction claim, granted under the revenue laws of the United States by Congress as a matter of legislative grace and where the rule of construction is strict.

C. Higgins' testimony in this connection also plainly refutes taxpayer's argument that the advances were made by way of loans, because he and Jones did not want the finders to participate in the cash that he and Jones had advanced. Obviously the issuance of preferred stock to Higgins and Jones would have genuinely represented the transaction and afforded them the protection necessary as against the finders. Indeed, Higgins made this suggestion at the outset, but Mr. Little, on account of the same Mexican law, advised the stockholders to express their investment under the form of loans. (R. 155-157.)

Exhibit 59 again discloses the true nature of the transaction, both by its provision that stock ownership,

i.e., proprietary interest, was to be geared upon the so-called loans, and also by its frank language (R. 301)—

> that all of the *contributions* of said parties, except the amount thereof required to pay up the 5,000 pesos capital stock of said corporation, shall be *regarded* as loans to said corporation, * * *. (Italics supplied.)

The further provision of Exhibit 59 that the "notes shall be payable either at or before their maturity, before any dividends shall be declared" (R. 301-302) again places the notes in a position of redeemable preferred stock rather than genuine debt and indicates that the "notes" were expected to be redeemed, like stock, out of earnings. Thus, it was again avoidance of an unfavorable Mexican law and not subordination of the finders' interests, that caused the critical contributions to be represented by so-called notes and not by preferred stock.

D. Although the notes were formally due two years from date and bore interest, no effort was made to collect them when due, nor was any effort made to collect interest upon them. Nevertheless, as appears from footnote 2, *supra,* at least twenty of Jones' notes fell "due" before or by the end of 1947 (Exs. 13-32), and during a period when high hopes were felt for the success of the venture. Undoubtedly, an equal part of Higgins' notes fell due during the same period. Had these obligations any reality as debt, or had there existed any real intent or expectation that payments should be made on the due dates, it is inconceivable that no claim would have been asserted or effort made to ob-

tain payment either of interest or of principal of any of them. Again, during part of this period (i.e., from November, 1946, to the end of 1947), at a time when the earlier notes were already falling due and without any pretense being made towards payment, Jones and Higgins were, nevertheless, making further contributions and receiving additional notes purportedly to be paid with interest in two years from date. Clearly no one reasonably could have expected the latter notes to be paid on their due dates any more than the earlier ones had been. Thus, the record indisputably discloses that the stated two year maturity dates of the loans lacked genuineness and reality. At all times the parties were merely placing their advances at the risk of the business.

E. Indeed, when the transaction was in the course of being wound up, the stockholders treated the so-called notes as subordinate obligations of the Mexican Corporation, not as they pretended to be, first obligations. Thus, as appears in the Statement, *supra,* the liquidating agreement between the engineer at the mine and the Mexican Corporation provided that before the proceeds of the sale of machinery and equipment was to be transferred to the Corporation, "all of the Company's outstanding accounts, pay rolls and liabilities" (Ex. 75, R. 345) were to be satisfied. Again, the corporate resolution, which provided for pro rata distribution to the holders of the notes of funds realized under this liquidating agreement and any other funds of the company provided that such funds were to be distributed "after payment of all prior liabilities." (Ex. 76, R. 353.) Thus, on liquidation the stockholders subordi-

nated their claims against the corporation represented by notes to the claims of creditors, and treated these securities not like debt, but like capital investment.

F. In *Schnitzer* v. *Commissioner, supra,* the Tax Court, in its opinion which, as already noted, formed the basis for this Court's affirmance, said (13 T.C. 43, 62):

> A corporation's financial structure in which a wholly inadequate part of the investment is attributed to stock while the bulk is represented by bonds or other evidence of indebtedness to stockholders is lacking in the substance necessary for recognition for tax purposes, and must be interpreted in accordance with realities.

Instantly, the part of the Mexican Corporation's financial structure attributed to stock was $1,000 as against supposed indebtedness to stockholders in excess of $308,000, or 1 to 308. The owners of a business should have as much or more in it than the creditors. Especially is this true of an enterprise which is so speculative as to be characterized by Higgins as "gambling". (R. 152.) As to the claim made at the hearing that the stock of the Mexican Corporation possessed value by way of "mining rights", there is little evidentiary basis for the $50,000 value stated by Jones. (R. 107.) There was also evidence of sales by the finder, Kroder, of 9% of the stock in April, 1945, for $5,000, and by co-finder, Johnson, of 9% in March, 1946, for $4,000. (R. 96-97; Ex. 60, R. 302-303; Ex. 63, R. 315-316.)

As a matter of fact, the valuation of the so-called mining rights as part of the original value of the stock

was apparently an after-thought. Certainly, the agreement (Ex. 59) pursuant to which the stock actually was distributed in proportion to other advances made to the corporation (R. 301) did not afford consideration of any value in the stock in addition to the 5,000 pesos or $1,000 paid in. If any real additional value was supposed to exist in the stock, it appears quite unlikely that the entire proprietary interest would have been geared exclusively on the future advances and to be determined after completion of the advances.

However, assuming, *arguendo,* that the stock possessed $50,000 in value, surely the resulting ratio of investment of $50,000 to $308,000 in debt, or more than one to six, of capital stock to indebtedness in this highly speculative enterprise, is completely unreal.

The instant situation is that of "an obviously excessive debt structure", adverted to by the Supreme Court in *John Kelley Co.* v. *Commissioner,* 326 U.S. 521, 526, as follows:

> As material amounts of capital were invested in stock, we need not consider the effect of extreme situations such as nominal stock investments and an obviously excessive debt structure.

With respect to a similar situation the Court of Appeals for the Fifth Circuit in *Arnold* v. *Phillips,* 117 F. 2d 497, certiorari denied, 313 U. S. 583, held as follows (p. 501):

> Those [advances] made before the enterprise was launched were, as the district court found, really capital. Although the charter provided for no more capital than $50,000, what it took to build the plant and equip it was a permanent investment, in

> its nature capital. There was no security asked or given. Arnold saw that he could not proceed with his enterprise unless he enlarged the capital. There can be little doubt that what he contributed to the plant was actually intended to be capital, notwithstanding the charter was not amended and demand notes were taken. The district court was justified in concluding as a matter of fact that the advances during the first year were capital, a sort of interest-bearing redeemable stock; and that as a matter of law these contributions could not, as against corporate creditors, either precedent or subsequent, be turned into secured debts by afterwards taking and recording a trust deed to secure them. *There was no debt to be secured.* (Italics supplied.)

While the cited case arose in a bankruptcy situation, it is notable that the holding of the court is placed upon the broad ground, irrelevant to bankruptcy, that "There was no debt to be secured." Here also substantially all the stockholders' advances were invested in purchase of the mines, plant, equipment and development, namely, original permanent capital investment. (Ex. 51, R. 247-252.)

Again, in a case where the attributes of legal form were far more fully complied with than in the instant record, the Tax Court in *1432 Broadway Corp.* v. *Commissioner,* 4 T. C. 1158, 1164-1165, said:

> The debentures are in approved legal form, and, if their legal attributes alone were determinative of the character of the interest accruals, there would be little room for doubt that they were the indebtedness they purport to be. Cf. *Clyde Bacon, Inc.,* 4 T. C. 1107. But, for tax purposes, their conformity to legal forms is not conclusive. Although

> a taxpayer has the right to cast his transactions in such form as he chooses, and the form he chooses will generally be respected, the Government is not required to acquiesce in the taxpayer's election of form as necessarily indicating the character of the transaction upon which his tax is to be determined. "The Government may look at actualities and upon determinaiton that the form employed for doing business or carrying out the challenged tax event is unreal or a sham may sustain or disregard the effect of the fiction as best serves the purposes of the tax statute." *Higgins* v. *Smith,* 308 U. S. 473. See also *Commissioner* v. *Court Holding Co.,* 324 U. S. 331. The Government is not bound to recognize as the substance or character of a transaction a technically elegant arrangement which a lawyer's ingenuity has devised. *Griffiths* v. *Commissioner,* 308 U. S. 355.

The cited case was affirmed by the Court of Appeals for the Second Circuit in 160 F. 2d 885, where it was pointed out that the Tax Court had "denied deduction on the ground that the evidence did not show that 'the debentures were, or were intended to be, evidences of indebtedness'; they were 'more nearly like preferred stock than indebtedness'." While the Court of Appeals, in view of the *John Kelley* case, *supra,* regarded these conclusions as not within the scope of its judicial review, it further stated:

> We may add, however, that, if the question were open to us, we should reach the same result as did the Tax Court.

See also to the same effect *Thomas* v. *Commissioner,* 2 T. C. 193; *Janeway* v. *Commissioner,* 2 T. C. 197, affirmed, 147 F. 2d 602 (C. A. 2d); *Swoby Corp.* v. *Com-*

missioner, 9 T. C. 887; Semel, Tax Consequences of Inadequate Capitalization, 48 Columbia L. Rev. 202 (March, 1948); Semel, Loan Versus Investment—Inadequate Capitalization, 5 Tax L. Rev. 424 (March, 1950).

Following the *Schnitzer* case, *Dobkin* v. *Commissioner,* 15 T. C. 31, affirmed by the Court of Appeals for the Second Circuit on the opinion of the Tax Court, 192 F. 2d 392, held advances were risk capital and not deductible as bad debts. In its opinion, the Tax Court, considering *inter alia* inadequate capitalization, notwithstanding that there so-called interest was paid on the alleged loans, said (p. 33):

> When the organizers of a new enterprise arbitrarily designate as loans the major portion of the funds they lay out in order to get the business established and under way, a strong inference arises that the entire amount paid in is a contribution to the corporation's capital and is placed at risk in the business. *Cohen* v. *Commissioner,* 148 Fed. (2d) 336; *Joseph B. Thomas,* 2 T. C. 193. The formal characterization as loans on the part of the controlling stockholders may be a relevant factor but it should not be permitted to obscure the true substance of the transaction. *Sam Schnitzer,* 13 T. C. 43, 60.

So also are the rulings in the recent cases of *Blair* v. *Commissioner,* 16 T. C. 90, 99, pending on appeal (C. A. 2d), and of *Matthiessen* v. *Commissioner,* 16 T. C. 781, 785-786, affirmed (C. A. 2d), February 15, 1952 (1952 C.C.H., par. 9201).

G. In *John Kelley Co.* v. *Commissioner, supra,* pp. 525-526, the Court there said:

> There is not present in either situation the wholly useless temporary compliance with statutory literalness which this Court condemned as futile, as a matter of law, in *Gregory* v. *Helvering,* 293 U. S. 465. The demonstrated possibility of sales by the holders of the obligations to persons other than stockholders alone proves the differentiation.

On the other hand, here it is submitted that there was the wholly useless temporary compliance with statutory literalness. With its nominal capitalization the Mexican Corporation could not have borrowed $308,000 on its unsecured notes in any arm's length transaction. The controlling stockholders gauged their proprietary interest on the amount of the advances; they never could have expected the amounts to be repaid in any event; indeed, they never sought their repayment as they fell due and were merely placing their contributions at the risk of the business. Indeed, indisputably they would not even have adopted the form of debt to represent the advances, except to avoid an unfavorable Mexican law.

But taxpayer corporation claims that it was not a stockholder of the Mexican Corporation, that the notes were sold to it for value, and in any event, this should constitute a differentiation. It is true that Jones sold the "notes" to taxpayer at their face value but, without recourse. (R. 92.) However, taxpayer was a mere *alter ego* for Jones and took with complete notice of all of the transactions involved. As appears from the Statement, *supra,* contributions made by Jones to the Mexican Corporation had been made by withdrawing funds from taxpayer corporation. (R. 92-93, 104-105.) Further, Jones and members of his family owned all the

outstanding stock of taxpayer corporation (R. 104), of which Jones personally owned from 47% to 59% between 1945 and 1948 (R. 109; Deft. Ex. 80, R. 364). Here is no case, such as is contemplated in *John Kelley Co., supra,* where obligations are sold to third parties at arm's length without notice. Clearly, if a security, actually risk capital in the hands of the original subscriber, can be transformed into a debt obligation by the mere formality of transfer without recourse to a wholly controlled family corporation, and a tax deduction thereby obtained, the intent of Congress would most facilely and flagrantly be obviated, and the statute nullified by mere passing of papers. Such a disregard of substance for form surely finds no place in a case where strict construction is the rule and the burden is upon the taxpayer to prove that the facts bring the case squarely within the deduction provisions of the statute.

CONCLUSION

For the reasons above given, the judgment of the District Court is erroneous and should be reversed.

Respectfully submitted,

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